[2016] UKFTT 526 (TC)

TC05275

Appeal number: TC/2013/3525

CORPORATION TAX – Derivative contracts – Derecognition of financial asset – Whether accounting debit fairly represents a loss from derivative contracts – Whether necessary to meet requirements of paragraph 15 of schedule 26 to Finance Act 2002 if debit within paragraph 25A of that schedule – Whether transfer pricing provisions of schedule 28AA Income and Corporations Taxes Act 1988 applicable – Appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

THE UNION CASTLE MAIL STEAMSHIP COMPANY LIMITED **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE JOHN BROOKS
MICHAEL SHARP FCA

Sitting in public at the Royal Courts of Justice, Strand, London on 20 – 23 June 2016

Jonathan Peacock QC and Philip Walford, instructed by Deloitte LLP, for the Appellant

Julian Ghosh QC and Ruth Jordan instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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DECISION

1. The Union Castle Mail Steamship Company Limited ("Union Castle") appeals against a closure notice, issued by HM Revenue and Customs ("HMRC") on 23 November 2012. This disallowed a deduction of £39,149,128 that Union Castle had claimed in respect of a debit arising from the derecognition of 95% of a financial asset, cash-flows of FTSE based derivative contracts, which it had entered into for commercial hedging reasons.

2. Union Castle was represented by Mr Jonathan Peacock QC and Mr Philip Walford. Mr Julian Ghosh QC and Ms Ruth Jordan appeared for HMRC. The written submissions and clear oral arguments from both sides were very much appreciated.

Facts

3. The parties produced the following Statement of Agreed Facts:

The Appellant

(1) The Appellant, Union Castle, was incorporated and registered with Companies House on 21 November 1989 with company number 02444991.

(2) Union Castle is a wholly owned subsidiary of Caledonia Investments plc ("Caledonia") (company number 00235481) and was so at all material times. Prior to 21 November 2008, Union Castle's issued share capital consisted of 502 shares of £1 each, fully paid, held by Caledonia.

(3) Caledonia is an approved Investment Trust Company under the terms of ss.1158-1159 Corporation Tax Act 2010 (formerly s.842 Income and Corporation Taxes Act 1988). As a consequence of this designation capital transactions entered into by Caledonia are not charged to tax.

(4) Union Castle is resident for tax purposes in the United Kingdom.

Purchase of the put options

(5) On 23 May 2007, there was a meeting of the board of directors of Caledonia, the minutes of which report that there was discussion about using put options against a FTSE index as a hedging strategy.

(6) It is recorded in the minutes that on 19 June 2007 there was a meeting of the administrative committee of Caledonia's board of directors. The minutes of the meeting record that the chairman reported that the directors believed that there was a significant risk of a fall in the UK equity markets within the next six months and that, to protect the value of Caledonia's investment portfolio, a series of FTSE 250 put options should be purchased. It was envisaged that up to £2m of put options should be purchased each month over the following five months, ie up to a total expenditure of £10m. However, the minutes of the meeting record that the directors expressed concern that if such put options were purchased by Caledonia they might imperil its investment trust status.

Accordingly, it was proposed that the put options should be purchased by Union Castle instead.

(7) The put option hedging was further discussed at meetings of Caledonia's board of directors on 20 June 2007, 19 July 2007, 19 September 2007 and 17 October 2007, as reported in the respective minutes.

(8) On 10 October 2007, Caledonia had received a presentation and report from Oxeye Capital Management Limited on a possible hedging product; however, as recorded in a memorandum of 5 November 2007 from Jonathan Hale to The Investment Management and Compliance Committees, the proposed action was that Caledonia would not modify its existing hedging strategy on the basis of this particular advice at this time.

(9) On 24 January 2008, there was a meeting of the administrative committee of Caledonia's board of directions, at which it was proposed that further put options should be purchased by Union Castle. The put option hedging was also discussed at a meeting of Caledonia's board of directors on 28 May 2008.

(10) Between 20 June and 31 December 2007, five FTSE put options at an aggregate cost of £10m were acquired by Union Castle. In January 2008, a further put option was acquired by Union Castle at a cost of £2m.

(11) In July 2008, the Association of Investment Companies published an exposure draft of a revised statement of recommended practice for financial statements of investment trust companies and venture capital trusts, which was regarded as clarifying the accounting treatment of derivatives for investment trusts (the "AIC SORP"). The complete new AIC SORP was published (and subsequently issued by the AIC) in January 2009, after which Union Castle did not purchase any further FTSE options.

(12) The put option hedging was further discussed at meetings of Caledonia's board of directors on 29 July 2008, 17 September 2008 and 29 October 2008, as reported in the respective minutes.

(13) During the financial year to 31 March 2009 the five put options acquired in 2007 were exercised by Union Castle. The proceeds were utilised to acquire a FTSE 250 put option for £2.1m, four FTSE 250 put spreads for £10.3m, a FTSE 100 put for £4.3m, to repay group borrowings and to pay UK tax to the Respondents on account. On 21 October 2008 one of the FTSE 250 put spreads acquired during the financial year to 31 March 2009 was sold for £5.2m.

(14) At 31 October 2008, Union Castle held the remaining 3 put options (2 FTSE 250 and 1 FTSE 100) and 3 put spreads (all of the above assets, taken together, are referred to as the "Options").

(15) On 19 November 2008, the minutes of a meeting of Caledonia's audit committee record that the committee considered a proposal to implement a structure which would achieve greater tax efficiency in relation to the FTSE options currently held by Union Castle. The minutes record that following the publication of the AIC SORP a sufficient level of comfort had been achieved that Caledonia itself could purchase FTSE options as a legitimate part of its investment activity. Consideration was given to novating the derivatives

contracts from Union Castle to Caledonia, although a tax charge would be crystallised in Union Castle based on the value of the options as a result. However, as an alternative, Deloitte had recently suggested that this might be done using a particular series of steps that had been disclosed under the Disclosure of Tax Avoidance Regulations (DOTAS) rules. In particular, Union Castle could issue a new class of share capital to Caledonia with dividend rights that would effectively transfer the economic benefit of the derivatives contracts. It was noted that in such circumstances, Union Castle would be obliged to apply pass-through accounting which would require it to write-off the value of the options thereby crystallising an equivalent tax loss. The matter was further referred to in the minutes of a meeting of Caledonia's board later the same day and the structure was implemented on 21 November 2008, and is the subject of the dispute in these proceedings.

The A Shares

(16) On 21 November 2008, Union Castle made a bonus issue to Caledonia of 5,020 shares (the "A Shares"). The existing shares were designated as Ordinary Shares, and the issue was made on the basis of 10 A Shares for every 1 existing Ordinary Share held by Caledonia.

(17) The A Shares of £1 each carried a right to receive a dividend equal to 95% of the cash flows arising on the close-out of the Options, such dividend to be paid within five business days following receipt of the option cash flows. As a consequence of issuing the A Shares Union Castle was required to derecognise 95% (£39,149,128) of the value of the Options for accounting purposes. The accounting position is summarised in paragraphs (23) to (33) below.

(18) Between 21 January and 24 August 2009, the Options were closed out by Union Castle. The gross close-out cash flows from the put options were £13,734,511 realised in January 2009 (accounting period ended 31 March 2009) and £11,308,034 realised between June and September 2009 (accounting period ended 31 March 2010).

(19) Between 26 January and 1 September 2009, Union Castle paid dividends to Caledonia in the sum equal to 95% of the cash flows.

The accounting position

(20) In the periods relevant to the appeal, Union Castle and Caledonia had each adopted international accounting standards, namely the set of standards consisting of International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and related Interpretations issued or adopted by the International Accounting Standards Board.

(21) Paragraphs (23) to (32) below set out the accounting treatment for the transactions.

(22) Prior to the A Shares being issued, Union Castle had all of the economic rewards and risks relating to its rights and obligations under the derivatives contracts. Accordingly, it was obliged to recognise the derivatives contracts as

financial assets, and to bring into account in its income statement subsequent movements in their fair value.

(23) Following the issue of the A Shares, Union Castle retained its rights and obligations under the derivatives contracts, but assumed an obligation to pay dividends equal to 95% of the future cash flows to the holder of the A Shares (Caledonia).

(24) The terms of the A Shares satisfy the requirements of paragraphs 19 to 23 of IAS 39 for the transfer of a financial asset. For this purpose, in accordance with paragraph 16 of IAS 39, the financial asset transferred is 95% of the cash flows of the derivatives contracts.

(25) Accordingly, Union Castle was required to derecognise that financial asset, being 95% of the cash flows of the derivatives contracts (in accordance with IAS 39, paragraph 20).

(26) On the issue of the A Shares, and given the requirement to credit the financial asset, the following debits and credits were recognised by Union Castle:

Cr financial asset	£39,149,128
Dr income statement	£39,149,128
Cr Share capital	£5,020
Dr Share premium	£5,020

(27) On the issue of the A Shares, a new security was added to Caledonia's investment ledger, but no cost attributed, as the bonus issue of A Shares was at nil cost. In addition, the A Shares were ascribed at fair value, which reflected the "pass-through" right to 95% of the future cash flows from the derivatives. Caledonia did not include an entry in its income statement, but reallocated a part of the fair value (which is the carrying value in the accounts) from the Ordinary Shares in Union Castle to the A Shares.

(28) Caledonia's accounting treatment is not in dispute, but Union Castle's accounting treatment is disputed in one respect. HMRC contend that the carrying value of the proportion of the derecognised derivatives contracts should be regarded as a transaction with owners in their capacity as owners under IAS 1, and that it may only be recognised in Union Castle in the statement of changes in equity.

(29) Union Castle does not consider that the dispute between the parties as to the tax treatment of the relevant transactions is influenced by whether the debit was required to be recognised in the statement of changes in equity, rather than the income statement. Accordingly, as Union Castle accepts that it may have been acceptable for the debit to be recognised in the statement of changes in equity, it is agreed that for the purposes of these proceedings the accounting treatment in accordance with generally accepted accounting practice in respect of Union Castle should be taken to be:

Cr financial asset £39,149,128

Dr statement of changes in equity £39,149,128

Cr Share capital £5,020

Dr Share premium £5,020

(30) In consequence of the derecognition of 95% of the fair value of the derivatives contracts, the parties agree that Union Castle was not permitted to subsequently bring into account in its income statement any debits or credits for subsequent movements in the fair value, save in relation to the 5% that had not been derecognised.

(31) Union Castle has informed HMRC that the derivatives that were the subject of the A Shares subsequently fell in value before they were closed out. The fall between November 2008 and 22 April 2009 is recorded in Caledonia's accounts, but was not deducted for tax purposes as it was treated as a capital item. It appears in Caledonia's income statement as part of "Gains and losses on investments held at fair value through profit or loss".

(32) Union Castle has not brought into account movements in the fair value of the derivatives contracts, except in relation to the 5 per cent which it still recognises in its accounts. However, for tax purposes, Union Castle has brought into account debits of £8,733,779 in respect of movements in 100 per cent of the fair value of the derivatives contracts since 22 April 2009. This is as a result of specific legislation enacted in the Finance Act 2009, and no dispute arises in relation to this.

Course of Dispute

(33) On 3 December 2009, Union Castle filed its corporation tax return for the year ended 31 March 2009 and claimed a deduction of £39,149,128. Union Castle also disclosed its participation in notifiable arrangements which had been given the scheme reference number 29977936.

(34) On 27 November 2008, Deloitte disclosed a scheme to HMRC in terms of the DOTAS Regulations entitled "Reserves Planning" and summarised the proposal or arrangements as follows:

> "A UK subsidiary (Finance Co) of parent (Parent Co) holds a derivative contract with a positive fair value. The Parent Co could be tax resident in the UK or another jurisdiction. Finance Co has reserves which it passes up to Parent Co by means of a bonus share issue of shares/securities, with the coupon linked to some or all of the cashflows, to the extent they are received, under the derivatives contract. Following the bonus share issue, the derivative is remeasured in Finance Co at its new fair value under generally accepted accounting practice (GAAP) on the basis that the amounts to be passed through to Parent Co are no longer recognised in Finance Co."

(35) On 1 June 2010, pursuant to paragraph 24 of Schedule 18 to the Finance Act 1998 ("FA 1998"), the Respondents opened an enquiry into Union Castle's corporation tax return for the year ended 31 March 2009.

(36) On 11 May 2012, prior to concluding the enquiry, the Respondents also sanctioned the inclusion of a transfer pricing determination within a future closure notice to be issued to the Appellant under Section 110 of FA 1998.

(37) On 23 November 2012, pursuant to paragraph 32 of Schedule 18 to FA 1998, the Respondents issued the Closure Notice and disallowed the deduction of £39,149,128 claimed by Union Castle.

(38) On 6 December 2012, Union Castle appealed to the Respondents on the basis that the Respondents' conclusions were wrong as a matter of fact and law. This appeal was acknowledged by the Respondents on 19 December 2012

(39) On 18 January 2013, the Respondents set out their reasons for not accepting the appeal and offered Union Castle a review. This offer was accepted on 14 February 2013.

(40) On 28 March 2013, by way of the review decision, the Respondents upheld the Closure Notice.

(41) On 26 April 2013, Union Castle submitted a Notice of Appeal to the Tribunal challenging the Respondents' amendment to its corporation tax return.

"Following Appellants" and key issues to be determined

(42) The appeal has been designated as a lead case for two other Appellants under Rule 18 of the Tribunal Procedure (First-tier Tribunal) Tax Chamber Rules 2009 (SI 2009/273) ("Rule 18"). The "following Appellants" are:

(a) Ladbrokes Group Finance plc – TC/2012/01365 ("Ladbrokes");

(b) IG Finance Five Ltd – TC/2013/00231("IG").

(43) The key issues to be determined are as follows:

(a) whether a debit that satisfies the requirements of paragraph 25A of Schedule 26 to the Finance Act 2002/s 605 Corporation Taxes Act 2009 is to be brought into account without regard to the requirement that it fairly represents a loss arising to it from its derivative contracts or whether the requirement contained in paragraph 25A of Schedule 26 to the Finance Act 2002/s 605 of the Corporation Taxes Act 2009 that it be brought into account "in the same way as a debit which is brought into account in determining the company's profit or loss for the period in accordance with generally accepting accounting practice" incorporates the requirement of paragraph 15 of Schedule 26 to the Finance Act 2002/s 595 Corporation Taxes Act 2009 that the debit must still fairly represent a loss arising to it from its derivative contracts;

(b) whether the debit consequent upon the issue by a subsidiary company to its parent company of bonus shares, the bonus shares carrying an entitlement to a dividend in an amount equal to all or a part of the cash flows receivable by the subsidiary company in respect of a derivative instrument held by the subsidiary fairly represents a loss arising to it from

its derivative contracts in accordance with paragraph 15 of Schedule 26 to the Finance Act 2002/s.595 Corporation Taxes 2009; and

(c) whether the issue of the bonus shares by the subsidiary company to its parent company is a provision that falls within the scope of the transfer pricing rules in s.147 Taxation (International and Other Provisions) Act 2010 or Schedule 28AA to the Income and Corporation Taxes Act 1988, and if so, whether (a) the arm's length price for a bonus issue would be different to the actual consideration received in respect of the bonus issue, (b) if yes, the effect, if any, under s.147 of the Taxation (International and Other Provisions) Act 2010 or Schedule 28AA to the Income and Corporation Taxes Act 1988 of increased proceeds for the issue of shares, and (c) the effect, if any, under s.693 Corporation Taxes Act 2009 in relation to the company's derivative contracts and the debits thereon.

(44) Issue (a) applies only to the Ladbrokes appeal however, as per the Rule 18 Direction, submissions on this matter will be made to the Tribunal, with the Tribunal requested to make findings on this point also.

(45) Issue (c) applies only to the appeals of Union Castle and IG.

(46) The issue of the appropriate accounting treatment for the transaction arises only in relation to the appeal of Union Castle, with the concession detailed above having been made in the context of the lead case proceedings in order to progress the matter.

4. Additionally, although not referred to in the Statement of Agreed Facts it is not disputed that by a letter dated 21 November 2008, the date Union Castle made the bonus issue of the A Shares (see paragraph 3(16), above), Caledonia undertook to Union Castle that, on the day before the cash settlement date for each of the option transactions to which the A Shares relate, it would:

> "…forthwith upon receipt of your demand in writing specifying the relevant amount shall make a capital contribution in cash to you in an amount equal to the option cash settlement amount receivable in respect of the relevant index option transaction less the amount of your distributable reserves (assuming respect of the relevant option cash settlement amount)."

Issues

5. As recorded in the Statement of Agreed Facts, and in accordance with the Rule 18 directions of the Tribunal issued on 25 February 2015, the issues arising in this appeal (in the order in which they were addressed before us) are:

(1) Whether the accounting debit of £39,149,128 fairly represents a loss arising to Union Castle from its derivatives contracts for the purposes of paragraph 15 of schedule 26 to the Finance Act 2002.

(2) In the case of a debit falling within para 25A of schedule 26 to the Finance Act 2002 whether it is still necessary to meet the requirements of

paragraph 15 of that schedule before it can be brought into account for tax purposes.

(3) Whether, if Union Castle would otherwise be entitled to a deduction in respect of the accounting debit, such a deduction should nevertheless be eliminated or reduced by a transfer pricing adjustment.

6. Mr Peacock described these as the Loss Issue, the Gateway Issue and the Transfer Pricing issue respectively. We shall do the same.

7. In addition, as is apparent from paragraph 3(28) and 3(29) above, there is also a dispute between the parties in relation to the accounting treatment of the derecognition, by Union Castle, of 95% of the financial asset. Expert evidence was led on this issue by both sides. It is common ground between the experts that it was right for Union Castle to derecognise 95% of the value of the Options (£39,149,128) as at 21 November 2008. However, Mr Peter Drummond, who gave evidence on behalf of HMRC, does not consider that the debit represents a loss for accounting purposes whereas Ms Pauline Wallace, who gave evidence on behalf of Union Castle does. Although neither party contends that this issue, the "Accounting Issue" is determinative we have, as a fact-finding Tribunal, been invited to resolve the disagreement between the experts in case of any further appeal. The Accounting Issue is, therefore, also considered below.

Application for inclusion of additional issue

8. On 2 June 2016 HMRC made an application, which was opposed by Union Castle, for the following further issue (the "In Respect of Issue") to be added to the Rule 18 direction in respect of the Ladbrokes appeal:

> "Whether the debit that arises upon the issue by a subsidiary company to its parent company of bonus shares, the bonus shares carrying an entitlement to a dividend in an amount equal to all or a part of the cash flows receivable by the subsidiary company in respect of a number of derivative instruments held by the subsidiary, is a debit that satisfies the requirements of paragraph 25A of Schedule 26 to the Finance Act 2002 (or its successor s 605 Corporation Tax Act 2009).

The application also sought permission to amend the Statement of Case accordingly.

9. The In Respect of Issue was considered by the Tribunal in *Stagecoach Group Plc v HMRC* [2016] UKFTT 120 (TC) ("*Stagecoach*") where it had been included following an unopposed application at the commencement of the hearing. Unlike this case, where the issue arises in relation to a related case, the In Respect of Issue related to the appellant in *Stagecoach*, which, albeit having similar issues to the present case, concerned loan relationships, not derivatives, and different legislation.

10. However, Mr Ghosh, for HMRC, said that this does not matter as the In Respect of Issue, ie whether a debit is "in respect of a derivative" is a pure question of law. He contended that if, as accepted, it is right that the Tribunal can decide whether that debit gives rise to a loss and whether that loss is "from" a derivative, it makes sense

for the Tribunal to also consider whether the debit is "in respect of" a derivative for the purposes of paragraph 25A of Schedule 26 to the Finance Act 2002, especially, he said, as the facts and accounting evidence is exactly the same and no further evidence is needed as Ladbrokes, like Union Castle, is bound by the Statement of Agreed Facts.

11. Mr Peacock accepted that the meaning of "in respect of" in this context is a question of law but contended that its application in a given case is a question of fact. He said that as the In Respect of Issue related to the Ladbrokes appeal it is necessary for it to be determined by reference to Ladbrokes facts which are different from the facts of Union Castle, eg Unions Castle is concerned with IAS and Ladbrokes UK GAAP. He also said that had HMRC raised this issue in July 2015, at the time it was raised in *Stagecoach*, it is possible the Union Castle may not have been selected as the lead appellant in this appeal.

12. We dismissed HMRC's application and did not permit either the addition of the In Respect of Issue or the Statement of Case to be amended. Although we gave brief reasons for our decision at the hearing we indicated that we would expand on these in our decision and now do so.

13. In essence we refused the application because the In Respect of Issue was solely in relation to the Ladbrokes appeal which, as Mr Peacock explained, did not have identical facts to Union Castle's appeal. It was therefore not possible to apply what was, undoubtedly a question of law, to facts that were not before us. Notwithstanding Mr Ghosh's submission that the Statement of Agreed Facts was binding on Ladbrokes it was prepared for Unions Castle's case and although binding on related appeals, such as Ladbrokes, is only binding insofar as it relates to common facts.

14. We also did not accept that we could simply apply the expert accountancy evidence to Ladbrokes appeal when neither expert had been instructed to consider the In Respect of Issue or Ladbrokes accounting. We also were concerned about the propriety of relying on an expert witness to give evidence on behalf of an appellant who had not been instructed by that appellant which had not taken any part in the decision to appoint her.

15. Additionally, the application could have been made in July 2015 at the time *Stagecoach* was being heard or in February 2016 when it was released. However, Mr Ghosh offered no explanation for the delay in making the application which was simply too late in the day, the experts had written their individual and joint reports without reference to the issue and the Statement of Agreed Facts finalised.

16. We now turn to each of the issues.

Accounting Issue

17. We were provided with Reports from each of the experts, Mr Drummond's dated 9 November 2015 and Ms Wallace's of 12 January 2016.

18. Mr Drummond is an advisory accountant employed by HMRC in their Large Business Unit where he advises HMRC's solicitors and policy specialists. Prior to his employment with HMRC he was employed by PricewaterhouseCoopers ("PwC"). Mr Drummond's impartiality as an expert witness was not questioned in cross-examination. Ms Wallace, a former partner of PwC, was the head of their financial instruments team. She was a member of the International Accounting Standards Board's IAS 39 Implementation Guidance Committee and has advised the Board in relation to proposed changes to IAS 32.

19. In addition to their individual Reports, Mr Drummond and Ms Wallace produced a Joint Report dated 8 March 2016 setting out what had been agreed and explaining the areas of disagreement. Both Ms Wallace and Mr Drummond Wallace gave oral evidence in which they further explained their respective views.

20. As we have previously noted it is common ground between the experts that it was right for Union Castle to derecognise 95% of the value of the Options. It is also accepted that the transfer of the economic benefits and risks and rewards associated with the Options as effected by the issue of the A Shares was reflected in the credit entry which was to financial assets and that the commitment by Caledonia to make a capital contribution to Union Castle (see paragraph 4, above) was not necessary in order for the criteria for derecognition to be met.

21. Where the experts differ is in relation to the corresponding debit entry, while they agree that it arises simultaneously with the credit out of the same transaction, Ms Wallace says the debit should be posted to profit and loss and Mr Drummond says that it a transaction with equity holders in their capacity as such (which he summarised as a shareholder transaction) and, as a distribution, should be posted to equity.

22. Mr Drummond summarised the "fundamental difference" between himself and Ms Wallace, saying:

> "I look at the substance of the transaction and I see a shareholder transaction … not something that would be done with an unconnected third party.
>
> That drives my view of the accounting. Ms Wallace does not see it like that. Instead Ms Wallace focuses on the notion that there is a financial liability that arises and because the accounting standards tell you that if payments are made in respect of financial liabilities then those are taken to profit and loss account.
>
> So I think in a nutshell that is the difference and as I have set out I don't agree that there is a financial liability, and I think that is clear from accounting standards."

23. It is therefore necessary to consider the relevant accounting standards.

24. The material part of IAS 1, *Presentation of Financial Statements*, provides:

> *Fair presentation and compliance with IFRSs*

13. Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

14. An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs.

15. In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity:

(a) to select and apply accounting policies in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of an IFRS that specifically applies to an item.

(b) to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.

(c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance

…

17. In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, the entity shall depart from that requirement in the manner set out in paragraph 18 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.

18. When an entity departs from a requirement of an IFRS in accordance with paragraph 17, it shall disclose:

(a) that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;

(b) that it has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation;

(c) the title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of

financial statements set out in the *Framework*, and the treatment adopted; and

(d) for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

25. Insofar as applicable IAS 39, *Financial Instruments: Recognition and Measurement*, provides:

…

17. An entity shall derecognise a financial asset when, and only when:

(a) …

(b) it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20.

(See paragraph 38 for regular way sales of financial assets.)

18. An entity transfers a financial asset if, and only if, it either:

(a) …

(b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19.

19. When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IAS 7 *Statement of cash flows*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

…

> 27. If the transferred asset is part of a larger financial asset (eg when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 16(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised. The difference between:
>
> (a) the carrying amount allocated to the part derecognised and
>
> (b) the sum of (i) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognised in other comprehensive income (see paragraph 55(b))
>
> shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in other comprehensive income is allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts.

26. Mr Drummond accepts that the test for derecognition under IAS 39 are met in relation to 95% of the Options and therefore the credit from the transaction. This is because although Union Castle, as a matter of law, retained the benefit of the cash flows under the derivative contract by issuing the bonus A Shares it has assumed a contractual obligation to pay an amount equal to 95% of those cash flows by means of dividends on those A Shares if they are received. However, he did not agree with Ms Wallace that IAS 39 should also be applied to debit side of the transaction preferring instead to apply IAS 1. Although he was clear that he did not consider that IAS 1 overrides IAS 39 but that IAS 39 did not apply to the debit side of the transaction as it did not deal with shareholder transactions whereas IAS 1 did.

27. Mr Ghosh submits that we should prefer Mr Drummond's approach, which took account of the nature of the transaction, to that of Ms Wallace. He described Ms Wallace's approach as "narrow and technical" leading to her offering a "purely mechanistic" reason for her view that the derecognition of the derivative contracts should for accounting purposes be treated as a loss. However, it seems to us that the application of accounting standards, given their nature, must call for a technical and consistent approach. Also that if a particular standard applies it must be applied in its entirety. Ms Wallace has done so in respect of IAS 39 whereas Mr Drummond has not.

28. Therefore, on balance, while we prefer the approach of Ms Wallace that the debit should be recorded in the income statement we also accept, as Ms Wallace herself recognised, recording the debit in the statement of changes in equity would also be valid.

The Loss Issue

29. All subsequent references to paragraphs, in relation to this and the Gateway Issue below are, unless stated otherwise, to paragraphs contained in schedule 26 to Finance Act 2002 which sets out the "derivatives code".

30. Paragraph 1(2) provides:

> Except where otherwise indicated, the amounts to be brought into account in accordance with this Schedule in respect of any matter are the only amounts to be brought into account for the purposes of corporation tax in respect of that matter.

31. Derivative contracts are defined by paragraph 2. It is common ground that the Options are derivatives contracts for the purposes of the code.

32. Paragraph 14(1) provides:

> For the purposes of corporation tax the profits and losses arising from the derivative contracts of a company shall be computed in accordance with this paragraph using the credits and debits given for the accounting period in question by the following provisions of this Schedule."

33. Paragraph 15, insofar as it applies to the present case, provides:

> (1) The credits and debits to be brought into account in the case of any company in respect of its derivative contracts shall be the sums which, when taken together, fairly represent, for the accounting period in question—
>
> (a) all profits and losses of the company which (disregarding any charges or expenses) arise to the company from its derivative contracts and related transactions; and
>
> (b) all charges and expenses incurred by the company under or for the purposes of its derivative contracts and related transactions.
>
> …
>
> (7) In this Schedule 'related transaction', in relation to a derivative contract, means any disposal or acquisition (in whole or in part) of rights or liabilities under the derivative contract.
>
> (8)The cases where there shall be taken for the purposes of sub-paragraph (7) to be a disposal or acquisition of rights or liabilities under a derivative contract shall include—
>
> (a) those where such rights or liabilities are transferred or extinguished by any sale, gift, surrender or release, and
>
> (b) those where the contract is discharged by performance in accordance with its terms.
>
> (9) This paragraph has effect subject to the following provisions of this Schedule.

34. Paragraph 17A(1) provides:

> (1) Subject to the provisions of this Schedule (including, in particular, paragraph 15(1)), the amounts to be brought into account by a company for any period for the purposes of this Schedule are those that, in accordance with generally accepted accounting practice, are recognised in determining the company's profit or loss for the period.

35. Paragraph 17A(2)–(4) deals with the position if a company does not draw up correct accounts and specify that the Schedule is to apply as if accounts in accordance with generally accepted accounting practice had been drawn up.

36. The amounts to be recognised are given by paragraph 17B which provides:

> (1) Any reference in this Schedule to an amount being recognised in determining a company's profit or loss for a period is to an amount being recognised for accounting purposes—
>
> (a) in the company's profit and loss account or income statement,
>
> (b) in the company's statement of recognised gains and losses or statement of changes in equity, or
>
> (c) in any other statement of items brought into account in computing the company's profits and losses for that period.
>
> (2) An amount that in accordance with generally accepted accounting practice is shown as a prior period adjustment in any such statement as is mentioned in sub-paragraph (1) shall be brought into account for the purposes of this Schedule in computing the company's profits and losses for the period to which the statement relates.
>
> This does not apply to an amount recognised for accounting purposes by way of correction of a fundamental error."

37. It is common ground that Union Castle required was to derecognise the Options as to 95% and did so be crediting the financial asset, the recognition of the obligation under the A Shares to pay up 95% of the cash received from the Options. The issue is in relation to the corresponding debit of £39,149,128 which is not necessarily the same amount as that received and paid up by Union Castle to Caledonia. It is also not disputed that the same transaction gives rise to the debit and credit, ie they must, as a result of the effect of the principles of double entry bookkeeping, both have the same source.

38. Although we have preferred the approach of Ms Wallace over that of Mr Drummond to the accounting treatment of the debit, it is clear from paragraph 17B that whichever approach had been adopted the debit is "recognised" under paragraph 17A "in determining" Union Castle's profit or loss for the period.

39. Section 50 of the Finance Act 2004 provides:

> (1) In the Corporation Tax Acts "generally accepted accounting practice" means—

> (a) in relation to the affairs of a company or other entity that prepares accounts in accordance with international accounting standards ("IAS accounts"), generally accepted accounting practice with respect to such items;
>
> (b) in any other case, UK generally accepted accounting practice.
>
> (2) In the Corporation Tax Acts "international accounting standards" has the same meaning as in Regulation (EC) No 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards

40. Therefore, as is clear from paragraph 15, the credits and debits to be brought into account shall be the sums which, when taken together, fairly represent, for the accounting period in question all profits and losses of the company which arise from its derivative contracts.

41. Three issues arise:

(1) Whether there is loss for these purposes;

(2) If so, does it arise "from" a derivative contract; and

(3) Does it meet the "fairly represent" requirement.

42. As in the present case, in *Abbey National Treasury Services v HMRC* [2015] SFTD 929 ("*ANTS*") the appellant needed to demonstrate that a debt (in that case of £160m) fairly represented a loss which had arisen from its derivative contracts under Part 1 of Schedule 26 to the Finance Act 2002 albeit in relation to tracker shares.

43. The Tribunal (Judge Short and Mr Dee) stated, under the sub-heading *Interpretation of Schedule 26 Finance Act 2002*:

> "83. Both parties argued, despite the architecture of Schedule 26 and the ostensible intention of the legislation to align accounting and tax profits, that the meaning of loss for the purposes of paragraph 15 of that Schedule was not an accounting, or at least not purely an accounting concept. Both referred to it as a legal concept, but with a different ambit; Mr Prosser [counsel for ANTS] said that a loss had to be recognised for paragraph 15 purposes because the result of the issue of the Tracker Shares was to diminish the value of ANTS' assets (its interest in the Swap cash flows) and this should pertain despite the fact that the accounting treatment of the transaction was to derecognise the asset and reflect the loss in statements of equity. Mr Ghosh [counsel for HMRC] said that the term loss in paragraph 15 bore a broad legal meaning but on no basis could the loss in value of assets arising from an agreement to pay on realised profits be treated as a loss for Schedule 26 purposes.
>
> 84. The issue is answered in part by paragraph 17B of Schedule 26 which does on its face enable the derivatives legislation to take account of debits which are taken to equity. Specifically amounts taken to equity are treated as recognised for accounting purposes and therefore fall within the scope of paragraph 17A as amounts which can be

brought into account as deductible debits. However, on this question of statutory interpretation we agree with Mr Ghosh that paragraph 17B and A are specific provisions which can be overridden by the general principles of paragraph 15 to which paragraph 17A is made explicitly subject. It is not all debits which are recognised in equity which can be treated as deductible debits, but only those which fulfil the other conditions of paragraph 15 in particular that they fairly represent all profits and losses of the company for the accounting period in question

85. Our starting point is that the derecognition debit which both parties accepted was the correct accounting treatment under IAS 39 cannot be accepted on its face as producing a fair representation of the company's losses arising from its derivative contracts without further analysis.

86. We agree with the approach of both parties that the reference to a loss in Schedule 26 should not be limited to a purely accounting concept and that the reference in paragraph 15 to reflecting only such losses and profits which fairly represent the company's position for that year is a means of ensuring that accounting treatment which is, for whatever reason, too far divorced from commercial reality should not be allowed to apply for tax purposes. (This is supported by the comments in the DCC Holdings Ltd decisions culminating in the Supreme Court decision (*DCC Holdings (UK) Ltd v Revenue and Customs Commissioners* [2010] UKSC 58) and reflected in later iterations of the legislation.) In this particular situation, as made clear by Mr Drummond, the accounting treatment is reflecting the economic substance of the transaction, that ANTS is obliged to pass on the payments which it receives under the Swaps which is out of line with ANTS' legal position, that it remains the counterparty to the Swaps and the recipient of the positive Swap Cash Flows.

87. Mr Prosser attempted to persuade us that there was a real loss because ANTS had passed on the cash flows under the Swaps and this had an impact on the value of the assets (the Swap cash flows) held by ANTS; Mr Ghosh took a different view of what had actually happened, that ANTS had merely entered into an agreement to pay on profits which it had received in the form of a dividend. On this point we agree with Mr Ghosh, for legal purposes ANTS was in exactly the same position as it always had been as far as the Swaps were concerned, it simply had an equal and opposite obligation to pay on receipts from those Swaps.

88. Mr Prosser argued that it was anomalous that two economically equivalent transactions (the assignment of the Swap Cash Flows and an agreement to pay them on on a back to back basis) should give rise to different tax results. We do not agree that this is an anomalous result in a tax code which does not operate on the basis of economic equivalence; the UK tax legislation does not generally elevate economic substance over legal form in circumstances where back to back arrangements are in place, which is what we consider Mr Prosser's argument is suggesting that we do.

89. Mr Drummond told us that if the Swap Cash Flows had been transferred to a non-shareholding third party, that element of the Swaps

would still have been derecognised under IAS 39, but the derecognition debit would have been taken to profit and loss account. In these circumstances it might have been more straightforward to accept that this represented a fair view of the company's profits as Mr Prosser suggested, arguing that the fact that the derecognition debit was taken to equity should make no difference to our analysis. We do not agree with this approach. IAS1 overrides IAS39 here for a reason; that there is no real loss in these circumstances, as Mr Drummond said "speaking as an accountant, I would say that in one scenario, there is no loss, whereas in the other it would be represented as an expense".

90. We come to this conclusion accepting that in some circumstances paragraph 17B of Schedule 26 provides for the possibility of recognising amounts taken to a company's statement of changes in equity as a deductible debit. We do not consider that these are circumstances in which paragraph 17B applies because neither the legal nor the accounting analysis suggests that a loss has been generated; for legal purposes ANTS has not disposed of any rights and for accounting purposes the disposal is treated as giving rise to a dividend.

91. We think that in substance and in form that should properly be treated as a distribution of profits, or a dividend, (as in fact was the result that IAS came to) and that this cannot be treated, on a fair view, as a loss giving rise to a debit under paragraph 15 of Schedule 26."

The Tribunal continued under, the subheading, *Arising from a derivative contract*:

"92. In order to succeed ANTS needs to demonstrate not just that there is a debit which can be recognised under paragraph 15 but also that this arises from a derivative contract; the only derivative contracts which were identified to us were the Swaps. As stated above, from ANTS' perspective (and also the Swap counterparties') nothing had changed as far as the terms of the Swaps were concerned; ANTS had just entered into a back to back agreement to make equivalent payments on to its parent entity.

93. For accounting purposes it was agreed that the derecognition deduction arose at the time when ANTS entered into the Tracker Share agreement, not at the time when payments were actually made on the Tracker Shares in 2009. ANTS claimed a deduction in 2008 not 2009 for the £160 million debit.

94. It is clear, at least for accounting purposes then, that what triggered the debit was not any actual payment made by ANTS in respect of the Swap Cash Flows, which were not made until 2009, but the issuing of the Tracker Shares. This is an agreement which is legally separate from the Swap contracts, although it derives its economic value from those Swap contracts. It is also worth nothing that according to Mr Drummond not only were the Swap Cash Flows transferred under the Tracker Shares, but as a result they changed from being a number of assets (the 26 Swaps) to a single asset, underlining their separation from the Swaps themselves.

> 95. While we accept that the Tracker Shares are connected to the Swaps, we do not think that this means that the source of the debit is the Swaps; the source of the debit, the thing which gave rise to a diminution in the value of ANTS' assets is the issue of the Tracker Shares and it was not suggested that this was a derivative contract. If it had not been for the Tracker Share terms, there would have been no impact on the value of the Swaps. (If for example ANTS simply happened to have, as many financial institutions would, matching swaps on its book and paid equal and opposite amounts out to a third party, while a debit would have been available for those third party payments, no debit would be treated as having arisen from the swaps which generated the positive cash flows).
>
> 96. The issue here is not that there is no loss, but that Schedule 26 is only intended to apply to losses derived directly from derivative contracts, which this is not. Schedule 26 applies to a defined set of transactions including "related transactions" (paragraph 15(7)) which extends to the assignment of rights under derivative contracts and a defined set of expenses, being expenses directly arising from derivative contracts (paragraph 15(4)). In our view this suggests that in order to be a debit arising from a derivative contract there has to be a direct nexus between the debit and the derivative contract, rather than the more remote causal link via the Tracker Share terms which exists here.
>
> 97. In this case, no income was assigned from the Swaps, no rights under the Swaps were transferred. The debit arose, as made clear by Mr Drummond, because of the contractual obligation to pay on the Swap Cash Flows under the Tracker Shares, which had no legal impact on the Swaps at all. This debit might be economically connected to, or related to, the derivative contracts, but it does not arise from those contracts as required by paragraph 15.
>
> 98. Our conclusion is that ANTS does not have a debit which can properly be recognised under Schedule 26; the "loss" generated by the derecognition debit is not a loss to which Schedule 26 applies and even if it were to such a loss, it does not arise from a derivative contract."

44. Although we were invited Mr Ghosh, who appeared for HMRC in *ANTS*, to adopt the reasoning of the Tribunal Mr Peacock contends that there are significant differences between that case and this and that the Tribunal reached the wrong conclusion in *ANTS*. As in that case it is common ground in the present case that the accountancy evidence is not determinative in resolving the issue of what is a matter law. As such, we do not accept that just because the appellant did not lead expert evidence to challenge that adduced by HMRC in *ANTS* we should disregard what the Tribunal had to say about the derivatives code in that case.

45. However, as Mr Peacock pointed out, the Tribunal in *ANTS* having recognised, at [84], that a debit to equity can be a loss appears to have subsequently concluded that there was not a loss relying on acceptance of Mr Drummond's evidence, a conflation of the legal and accounting effect of the transaction and have failed to recognise the logical consequence of their conclusion that a debit to equity can amount to a loss. With regard to arising "from a derivative contract" the Tribunal, while it accepted, at [95], that the Tracker Shares were connected to the Swaps it did

not think that the Swaps were the source of the debit but that the issue of the Tacker Shares, which was not a derivative contract, was. It continued, at [96], saying that "schedule 26 is only intended to apply to losses derived directly from derivative contracts" and that there has to be a "direct nexus" between the debit and the derivative contract.

46. However, the legislation does not refer to a direct relationship between a debit and derivative contract. It refers to a loss arising "from" not "directly from" its derivative contracts. The Tribunal also appears to have concluded that the debit has a different source to the credit finding that the source of the credit to be the derecognition of the derivatives and the source of the debit the issue of the Tracker Shares. Such a conclusion, that the credit has a direct nexus with the derivative but the debit does not, is inconsistent with the principles of double entry bookkeeping and clearly not in accordance with the accountancy evidence led in the present case.

47. Therefore, for these reasons we are unable to adopt the reasoning in *ANTS* and consider afresh whether there is a loss, if so, whether it arises "from" a derivative contract; and whether it satisfies the "fairly represent" requirement.

Loss

48. Mr Peacock says that there is a loss. Before the derecognition of the derivative contracts Union Castle had 100% of their economic benefit but only 5% after 95% was passed to Caledonia. There was, he says, a loss of 95% of an asset.

49. However, we prefer the argument of Mr Ghosh who says that there is no loss as Union Castle received the cash benefit under the derivative contracts and gave it away. As such the debit cannot be a loss for Union Castle which after the issue of the A Shares was entitled to exactly the same amount as it was before the issue of those shares. There has not been a diminution in the resources of Union Castle and therefore no real loss.

50. Having come to such a conclusion Union Castle's appeal (and those of the related appellants) cannot succeed. However, as all matters were fully argued before us and in case of any further appeal we consider that if there had been a loss, whether it was "from" the derivatives and if the "fairly represent" requirement is met before considering the Gateway and Transfer Pricing Issues.

From derivatives

51. If we are wrong and there is a loss Mr Peacock contends that it arises "from" the derivative contracts. He says that the debit matches and corresponds to the credit with both arising from the same transaction, the issue of the A Shares which gave rise to the derecognition of the economic benefit of the derivatives the asset formerly on the balance sheet. However, Mr Ghosh disagrees, relying on the reasoning of the Tribunal in *ANTS* he contends that the source of the loss (if there is one) is the issue of the A Shares which, on Ms Wallace's evidence, gave rise to the financial liability.

52. However, for the reasons above (in paragraphs 46 and 47) we have declined to apply the reasoning in *ANTS* and, given Mr Ghosh's reliance on it, we consider that if there had been a loss it would have been, albeit indirectly, "from" the derivatives.

Fairly represents

53. On the assumption that we had found that there was a loss arising from derivatives Mr Peacock submits that "fairly represents" is first, a means of identifying from entries in the accounts those things which have to do with derivatives ie an allocation or, as Mr Ghosh says, an attribution role and secondly, a timing role identifying that which is appropriate in a particular accounting period.

54. Mr Ghosh submits that "fairly represents", in addition to an attribution and timing role, may allow HMRC to adjust credits or relevant debits and might constitute some form of override and allow HMRC to rewrite Debits and Credits because it would be fair to do so and referred such an approach being taken by the Tribunal (Judge Short and Mr Collard) in *GDF Suez Teesside Limited (Formerly Teesside Power Limited) v HMRC* [2015] UKFTT 413 (TC) ("*Suez*").

55. However, *Suez* was concerned with the loan relationships code. The Tribunal in *Stagecoach*, which also concerned loan relationships, recorded at [110] that it did not:

> "… derive assistance from … what were said to be mirror provisions in the derivatives' code. We were referred to … FA 2002 schedule 26… The language and context are not identical and the analogy advanced, unsupported by authority, was not in our view, persuasive, notwithstanding Ms Shaw's [counsel for Stagecoach] able and powerful presentation."

We consider the reverse to also be true and consequently cannot derive assistance from the loan relationship code in the different context of this appeal, an appeal concerning the derivative code.

56. As such, we consider that "fairly represents" must therefore have a timing and/or allocation role as both Mr Peacock and Mr Ghosh recognised. Accordingly, the loss, there had been one, would, in our view, have satisfied the fairly represents requirement.

Conclusion on the Loss Issue

57. We consider that if there had been a loss it would have been "from" the derivative contracts and fairly represented the accounting period in question. However, for the reasons above we are unable to conclude that there was a loss as a result of the debit

The Gateway Issue

58. In essence this issue, which concerns only Ladbrokes appeal, concerns whether, in the case of a debit falling within paragraph 25A the requirements of paragraph 15 have to be met before it can be brought into account.

59. Paragraph 25A provides:

> Where in accordance with generally accepted accounting practice a debit or credit for a period in respect of a derivative contract of a company—
>
> (a) is recognised in equity or shareholders' funds, and
>
> (b) is not recognised in any of the statements mentioned in paragraph 17B(1)
>
> the debit or credit shall be brought into account for that period for the purposes of this Chapter in the same way as a debit or credit that, in accordance with generally accepted accounting practice, is brought into account in determining the company's profit or loss for that period.

60. It is common ground that Ladbrokes meets the terms of paragraph 25A in that there is a debit which is taken to equity and not recognised in the statements mentioned in paragraph 17B.

61. Mr Peacock refers back to paragraph 14 which provides that, for Corporation Tax purposes, the losses arising from derivative contracts are to be computed according to paragraph 14 using the credits and debits given by the provisions of schedule 26.

62. Paragraph 15, as we have seen, provides for the identification of the debits and credits which represent profits and losses in accordance with GAAP which is determined by reference to paragraph 17A to a statement listed in paragraph 17B. Therefore, for a paragraph 17B statement the route is paragraph 17B to paragraph 17A to paragraph 15 to paragraph 14. However, where a statement is not recognised in paragraph 17B paragraph 25A applies. In such circumstances Mr Peacock contends that because paragraph 25A makes provision for debits and credits not listed in paragraph 17B it is not necessary to go to paragraph 15 but directly to paragraph 14.

63. Mr Peacock says that paragraph 15 plays two roles when following the statutory route from paragraphs 17B to 17A to 15. First setting out that the debits and credits to be brought into account have to be in respect of derivative contracts and secondly, that they have to be appropriate to the right accounting period. These two roles, he submits, are also played by paragraph 25A. It is a prerequisite of paragraph 25A that there is a debit or credit in respect of a derivative contract and for a particular period. Therefore, having applied paragraph 25A it is not necessary to meet the requirements of paragraph 15 as these have already been met in the application of paragraph 25A.

64. Mr Ghosh, while accepting that the legislation was not "elegantly drafted", contends that paragraph 25A provides that if a statement is not recognised in any of the paragraph 17B statements but is recognised elsewhere it is to be brought into

account for derivatives purposes in the same way as a debit or credit that in accordance with GAAP is brought into account in determining the company's profit or loss and is simply a deeming a credit or debit that has gone to equity to be a paragraph 17B debit or credit. He referred to *Stagecoach* which considered s 320 of the Corporation Taxes Act 2009. Mr Ghosh described this as the "analogue of paragraph 25A for derivatives purposes" and the "analogue" of the gateway issue.

65. At [124] in *Stagecoach* the Tribunal stated:

> "The phrase *in the same way* provides the connection between ss 320 and 307(3). Otherwise, it seems to have no function. *Group* appears to read s320(2) as if the words in the same way as a credit or debit which is brought into account were omitted. That does not seem to us to be the correct approach. In the same way seems to us to refer to the general circumstances in which the credit or debit may be brought into account and these are set forth in s307(3). The Parliamentary draftsman has used a different form of cross reference in s332, perhaps for emphasis because that section is dealing with specific types of financial arrangements (repo or stock lending arrangements)."

66. Mr Ghosh explained that the Tribunal was saying that s 320 was "plugging you back" into s 307 in the same way that paragraph 35A was referring back to paragraphs 17A and 17B and on to paragraph 15. However, not only is it clear that the observations of the Tribunal at [124] were *obiter* but that the legislation considered, although similar, was not the equivalent of paragraph 25A and, as we have already noted (see paragraph 55, above) *Stagecoach* concerned the loan relationships code rather than the derivatives code and is therefore of little, if any, assistance.

67. We agree with Mr Peacock that paragraph 25A fulfils the role, in the absence of paragraph 17B statements, played by of paragraph 15 where such paragraph 17B statements are present. We therefore consider it to be unnecessary in the case of a debit falling within paragraph 25A for the requirements of paragraph 15 have to be met before it can be brought into account.

The Transfer Pricing Issue

68. As a result of our decision that there is not a loss, the provisions relating to transfer pricing are not applicable. However, to consider whether any deduction to which Union Castle would have been entitled had we concluded otherwise should be eliminated or reduced by a transfer pricing adjustment it is necessary to proceed on the assumption that (contrary to our conclusion) the debit did result in a loss for Union Castle.

69. Paragraph 31A of schedule 26 to the Finance Act 2002 provides:

> (1) This paragraph applies where, in pursuance of Schedule 28AA to the Taxes Act 1988 (provision not at arm's length), an amount falls to be treated as any of the following—

(a) an amount of profits or losses (disregarding any charges or expenses) arising to a company from any of its derivative contracts or related transactions;

(b) charges or expenses incurred by a company under or for the purposes of any of its derivative contracts or related transactions.

(2) That Schedule shall have effect so as to require credits or debits relating to the amount so treated to be brought into account for the purposes of this Chapter to the same extent as they would be in the case of an actual amount of—

(a) profits or losses (disregarding any charges or expenses) arising to the company from the derivative contract or related transaction, or

(b)charges or expenses incurred under or for the purposes of the derivative contract or related transaction,

as the case may be."

70. The general transfer-pricing provisions are contained in schedule 28AA to the Income and Corporation Taxes Act 1988 ("ICTA") the relevant paragraphs of which provide as follows:

Basic Rule on Transfer Pricing etc

1—

(1)This Schedule applies where—

(a) provision ('the actual provision') has been made or imposed as between any two persons ('the affected persons') by means of a transaction or series of transactions, and

(b) at the time of the making or imposition of the actual provision—

(i) one of the affected persons was directly or indirectly participating in the management, control or capital of the other; or

(ii) the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons.

(2) Subject to paragraphs 5A, 5B, 8, 10 and 13 below, if the actual provision—

(a) differs from the provision ('the arm's length provision') which would have been made as between independent enterprises, and

(b) confers a potential advantage in relation to United Kingdom taxation on one of the affected persons, or (whether or not the same advantage) on each of them,

the profits and losses of the potentially advantaged person or, as the case may be, of each of the potentially advantaged persons shall be computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

(3) For the purposes of this Schedule the cases in which provision made or imposed as between any two persons is to be taken to differ from the provision that would have been made as between independent enterprises shall include the case in which provision is made or imposed as between any two persons but no provision would have been made as between independent enterprises; and references in this Schedule to the arm's length provision shall be construed accordingly.

…

Principles for constructing rules in accordance with OECD principles

2—

(1) This Schedule shall be construed (subject to paragraphs 8 to 11 below) in such manner as best secures consistency between—

(a) the effect given to paragraph 1 above; and

(b) the effect which, in accordance with the transfer pricing guidelines, is to be given, in cases where double taxation arrangements incorporate the whole or any part of the OECD model, to so much of the arrangements as does so.

(2) In this paragraph 'the OECD model' means—

(a) the rules which, at the passing of this Act, were contained in Article 9 of the Model Tax Convention on Income and on Capital published by the Organisation for Economic Cooperation and Development; or

(b) any rules in the same or equivalent terms.

(3) In this paragraph 'the transfer pricing guidelines' means—

(a) all the documents published by the Organisation for Economic Co-operation and Development, at any time before 1st May 1998, as part of their Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations; and

(b) such documents published by that Organisation on or after that date as may for the purposes of this Schedule be designated, by an order made by the Treasury, as comprised in the transfer pricing guidelines."

Meaning of "transaction" and "series of transactions"

3—

(1) In this Schedule "transaction" includes arrangements, understandings and mutual practices (whether or not they are, or are intended to be, legally enforceable).

…

(5) In this paragraph, "arrangement" means any scheme or arrangement of any kind (whether or not it is, or is intended to be, legally enforceable).

Participation in the management, control or capital of a person

4—

(1) For the purposes of this Schedule a person is directly participating in the management, control or capital of another person at a particular time if, and only if, that other person is at that time–

(a) a body corporate or a partnership; and

(b) controlled by the first person.

(2) For the purposes of this Schedule a person ("the potential participant") is indirectly participating in the management, control or capital of another person at a particular time if, and (subject to paragraphs 4A and 6(4C)) only if–

(a) he would be taken to be directly so participating at that time if the rights and powers attributed to him included all the rights and powers mentioned in sub-paragraph (3) below that are not already attributed to him for the purposes of sub-paragraph (1) above; or

(b) he is, at that time, one of a number of major participants in that other person´s enterprise.

(3) The rights and powers referred to in sub-paragraph (2)(a) above are–

(a) rights and powers which the potential participant is entitled to acquire at a future date or which he will, at a future date, become entitled to acquire;

(b) rights and powers of persons other than the potential participant to the extent that they are rights or powers falling within sub-paragraph (4) below;

(c) rights and powers of any person with whom the potential participant is connected; and

(d) rights and powers which for the purposes of sub-paragraph (2)(a) above would be attributed to a person with whom the potential participant is connected if that connected person were himself the potential participant.

(4) Rights and powers fall within this sub-paragraph to the extent that they–

(a) are required, or may be required, to be exercised in any one or more of the following ways, that is to say–

(i) on behalf of the potential participant;

(ii) under the direction of the potential participant; or

(iii) for the benefit of the potential participant;

and

(b) are not confined, in a case where a loan has been made by one person to another, to rights and powers conferred in relation to

property of the borrower by the terms of any security relating to the loan.

…

Paragraph 4A

4A—

(1) A person ("P") shall be treated for the purposes of paragraph 1(1)(b)(i) above (but subject to sub-paragraph (7) below) as indirectly participating in the management, control or capital of another ("A") at the time of the making or imposition of the actual provision if–

(a) the actual provision relates, to any extent, to financing arrangements for A;

(b) A is a body corporate or partnership;

(c) P and other persons acted together in relation to the financing arrangements; and

(d) P would be taken to have control of A if, at any relevant time, there were attributed to P the rights and powers of each of the other persons mentioned in paragraph (c) above.

…

Advantage in relation to United Kingdom taxation

5—

(1) For the purposes of this Schedule the actual provision confers a potential advantage on a person in relation to United Kingdom taxation wherever, disregarding this Schedule, the effect of making or imposing the actual provision, instead of the arm´s length provision, would be one or both of the following, that is to say–

(a) that a smaller amount (which may be nil) would be taken for tax purposes to be the amount of that person´s profits for any chargeable period; or

(b) that a larger amount (or, if there would not otherwise have been losses, any amount of more than nil) would be taken for tax purposes to be the amount for any chargeable period of any losses of that person.

…

Saving for the provisions relating to capital allowances and capital gains

13—

(1) Subject to sub-paragraph (2) below, nothing in this Schedule shall be construed as affecting–

> (a) the computation of the amount of any capital allowance or balancing charge made under the 1990 Act; or
>
> (b) the computation in accordance with the 1992 Act of the amount of any chargeable gain or allowable loss;
>
> and nothing in this Schedule shall require the profits or losses of any person to be computed for tax purposes as if, in his case, instead of income or losses falling to be brought into account in connection with the taxation of income, there were gains or losses falling to be brought into account in accordance with the 1992 Act.
>
> (2) Nothing in sub-paragraph (1) above applies to paragraph 6 above.
>
> *General interpretation etc.*
>
> 14—
>
> (1) In this Schedule–
>
> "the actual provision" and "the affected persons" shall be construed in accordance with paragraph 1(1) above;
>
> "the arm"s length provision' shall be construed in accordance with paragraph 1(2) and (3) above;
>
> …
>
> (2) Without prejudice to paragraphs 9(2) and 11(3) above, references in this Schedule to a person controlling a body corporate or a partnership shall be construed in accordance with section 840 [ICTA].

71. Section 840 ICTA provides:

> For the purposes of, and subject to, the provision of the Corporation Tax Acts which apply this section, "control", in relation to a body corporate, means the power of a person to secure—
>
> (a) by means of holding the shares or the possession of voting power in or in relation to that or any other body corporate; or
>
> (b) by virtue of any powers conferred by the articles of association or other document regulating that or any other body corporate,
>
> that the affairs of the first-mentioned body corporate are conducted in accordance with the wishes of that person, and in relation to a partnership, means the right to a share of more than one-half of the assets, or of more than one-half of the income, of the partnership.

72. Article 9 of the Model Tax Convention (Associated Companies) published by the Organisation for Economic Cooperation and Development ("OECD"), which according to the OECD Transfer Pricing Guidelines "sets forth" the international standard that OECD Member countries have agreed should be used for determining transfer process for tax purposes, provides (insofar as is material to the present case):

> 1. Where

> (a) an enterprise of a Contracting State participates directly or indirectly in the
>
> management, control or capital of an enterprise of the other Contracting State, or
>
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

(Article 3 of the OECD model defines the term “enterprise” as applying “to the carrying on of any business.”)

73. We were referred to the OECD Transfer Pricing Guidelines in relation to the Arm’s Length Principle which are expressed in terms of the provision of goods or services (see eg paragraph 1.19 ‘Characteristics of property or services’) and the following paragraphs of those Guidelines in particular:

> 1.28 In arm’s length dealings, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be a part of the functional analysis discussed above. The terms of a transactions may also be found in correspondence/communications between the parties other than a written contract. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.
>
> 1.29 In dealings between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties’ conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.

74. Paragraph 1.36 states that a tax administration’s examination of a transaction between associated enterprises should “ordinarily be based on the transaction actually undertaken” between them and should not, other than in “exceptional cases”, disregard or substitute the transaction. Paragraph 1.37 provides:

> However, there are two particular circumstances in which it may, exceptionally, be appropriate and legitimate for a taxpayer in entering into a controlled transaction [ie a transaction between associated enterprises]. The first circumstance [which is not relevant to the present case] … The second circumstance arises where, while the form and substance of the transactions are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

75. Chapter 7 of the OECD guidelines 'Special Consideration for Intra-Group Services' recognises that although there may be a shareholder relationship between one enterprise and another a distinction should be drawn between activities under that relationship other non-shareholder activities between them. Paragraphs 7.9 and 7.10 provide:

> 7.9 A more complex analysis is necessary where an associated enterprise undertakes activities that relate to more than one member of the group or to the group as a whole. In a narrow range of such cases, an intra-group activity may be performed relating to group members even though those group members do not need the activity (and would not be willing to pay for it were they independent enterprises). Such an activity would be that one group member (usually the parent company or a regional holding company) performs solely because of its ownership interest in one or more other group members, ie in its capacity as shareholder. It may be referred to as a "shareholder activity", distinguishable from the broader term "stewardship activity" used in the 1979 Report. Stewardship activities covered a range of activities by a shareholder that may include the provision of services to other group members, for example services that would be provided by a coordinating service. These latter types of non-shareholder activities could include detailed planning services for particular operations, emergency management or technical advice (trouble shooting), or in some cases assistance in day to day management.
>
> 7.10 The following examples (which were described in the 1984 Report) will constitute shareholder activities under the standard set forth in paragraph 7.6:
>
> (a) Costs of activities relating to the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company and costs of the supervisory board;
>
> (b) Costs relating to reporting requirements of the parent company including the consolidation of reports;
>
> (c) Costs of raising funds for the acquisition of its participations.
>
> In contrast, if for example a parent company raises funds on behalf of another group member which uses them to acquire a new company, the parent company would generally be regarded as providing a service to the group member. The 1984 Report also mentioned "costs of

> managerial and control (monitoring) activities related to the management and protection of the investment as such in participations". Whether these activities fall within the definition of shareholder activities as defined in these Guidelines would be determined according to whether under comparable facts and circumstances the activity is one that an independent enterprise would have been willing to pay for or perform for itself.

76. Also the OECD Model Treaty Commentary on Article 9, at paragraph 3(b), distinguishes between debt finance that is covered by transfer pricing and equity finance which is not.

77. Therefore, for there to be any transfer pricing adjustment it is necessary for there to be a provision, "the actual provision" made or imposed between two persons which differs from the provision that would have been made as between independent enterprises with the term "provision" being construed in such manner as "best secures consistency" with Article 9 of the OECD Model Tax Convention and the OECD transfer pricing guidelines. Mr Ghosh contends that the "provision" is the issue of the A Shares by Union Castle to Caledonia whereas Mr Peacock's case is that because the issue of shares does not bear the character of making or imposing conditions in commercial and financial relations it does not amount to a "provision" for the purposes of schedule 28AA ICTA.

78. These transfer pricing provisions were considered by the Tribunal in *ANTS* which observed, albeit *obiter*, that:

> "101. … there is nothing in Schedule 28AA itself or indeed Article 9 of the OECD model convention and its Guidance Notes which specifically takes the issue of shares outside the transfer pricing rules. We do not agree with Mr Prosser's rather narrow interpretation of "commercial and financial relations" in this context which we think is wide enough to include a share issue which could, in circumstances other than those under consideration here, influence the relationship between a holder and issuer of shares.
>
> 102. We consider that Mr Prosser's approach to be an overly restrictive and incorrect application of the Schedule 28AA rules. We think that the reason that share issuances have not been the subject of Schedule 28AA in the UK is because there is a plethora of other legislation on the UK statute book which controls the manner in which equity capital can be used to manipulate profits between related companies. Our conclusion is that the issue of the Tracker Shares can be treated as a provision to which Schedule 28AA applies and that the UK transfer pricing rules are in point."

79. The Tribunal continued:

> "104. Mr Prosser attempted to suggest that shares with terms similar to the Tracker Shares could have been issued between independent enterprises, citing a proportionate issue of bonus shares of a particular class as similar to the Tracker Shares. We do not think that this is an apt analogy for the issue of shares such as the Tracker Shares whose

> market value was £161 million but which were issued at £1,000. Bonus shares of the type described by Mr Prosser would not be paid for at all and would not comprise a defined and valued set of cash flows as the Tracker Shares did. It is very difficult to imagine a comparable commercial situation in which a company would be willing to give away £160 million of value in exchange for £1,000 to a third party. To use the terms of the OECD Guidelines, it does not represent "commercially rational" behaviour.
>
> 105. Mr Prosser stressed that the OECD Guidelines placed clear restrictions on tax authorities either disregarding or substituting another transaction for the actual transaction carried out between the parties other than in the specific circumstances set out at paragraph 1.37. Our view is that the Tracker Shares do fall within one of those exceptions, namely that "the arrangements in relation to the transactions viewed in their totality, differ from those that would have been adopted by independent enterprises acting in a commercially rational manner and the structure impedes the tax administration from determining the appropriate transfer price". The example given in the guidelines of a transaction falling within this exception is of an agreement whose legal terms (the length of the contract), rather than merely its price, has to be taken account of. On this analysis we think that the Tracker Shares (including the Compensation Agreement), by reason of their legal character, not being the type of shares which would be issued between independent parties, fall within this exceptional category. We also think that the fact that the Tracker Shares were issued as part of a transaction which was notified to HMRC under the DOTAS rules supports this conclusion.
>
> 106. Our conclusion on these points is that the Tracker Shares are a provision for Schedule 28AA purposes and that the comparator transaction is that they would not have been issued at all between independent enterprises with the result that any debit arising should be reduced to nil."

80. In essence the argument advanced by Mr Ghosh is that accepted by the Tribunal in *ANTS*, that parties acting at arm's length would simply not have entered into the transaction involving the issue of the A Shares. Accordingly, he says, by applying the transfer pricing provisions the issue of the A Shares and consequent derecognition of the relevant cash flows are treated by paragraph 1(3) of schedule 28AA ICTA as having not occurred thereby eliminating the debit for which Union Castle may claim relief. As in *ANTS* HMRC are asking for decision in principle and that it be left to parties to subsequently agree the appropriate figures.

81. Mr Peacock, however, contends that *ANTS* was wrongly decided. In particular, he takes issue with the reasoning of the Tribunal in concluding that "share issuances" have not been the subject of schedule 28AA ICTA in the UK because there is a "plethora of other legislation on the UK statute book which controls the manner in which equity capital can be used to manipulate profits between related companies" and that the transactions can be re-characterised because the type of shares that were issued would not have been issued between independent parties.

82. We accept Mr Peacock's submission that just because there is a plethora of other legislation dealing with equity provisions it does not follow that schedule 28AA ICTA applies. It is equally true that the existence of other provisions does not exclude it either. The Tribunal in *ANTS* also did not consider it appropriate to view the 'Compensation Agreement', the equivalent to the commitment by Caledonia to make a capital contribution to Union Castle in the present case, as a separate condition whereas in the present case it was common ground between the experts that this commitment by Caledonia did not have any bearing on the derecognition of 95% of the value of the Options. It is also accepted that if the transfer pricing provisions did apply and an adjustment was necessary on a bonus issue of shares it would be necessary to postulate a situation where Caledonia held shares in Union Castle but was not a controlling shareholder. In such circumstances, and contrary to the conclusion in *ANTS*, we consider the issue of bonus shares to be an arm's length transaction.

83. Mr Peacock's primary argument is that transfer pricing principles do not apply to shareholder or equity transactions and other than in *ANTS*, the proposition advanced on behalf of HMRC that these principles are applicable has not been accepted by the UK courts.

84. He referred to *Ametalco UK v Inland Revenue Commissioners* [1996] STC (SCD) 399, which concerned the earlier transfer pricing provisions contained in s 770 ICTA, where it was not disputed that a subscription for shares in an associated company was not within the ambit of transfer of these provision. No such concession was made by Mr Ghosh in the present case.

85. Mr Peacock also took as to the decision of the High Court of Judicature at Bombay in *Vodafone India Services Pvt v Union of India and others* (2014) 17 ITLR 209. In that case the Indian subsidiary issued shares to its non-Indian parent company at a subscription price which was said to have been below market value. The Indian Revenue sought to advance a transfer pricing argument in relation to the share issue. This was rejected by the court. Its conclusion is summarised in the headnote as follows:

> "A condition precedent for the application of the transfer pricing regime was that income had arisen. The transfer pricing regime was the measure of tax but it first had to be shown that the payment was subject to tax. The amounts received on the issue of share capital were on capital account and any amount forgone was not included in the concept of income or notional income on the absence of statutory provision. The legislature had provided for bringing within the ambit of income any amount received in excess of fair market value, but not capital received."

86. However, Mr Ghosh did not suggest that the effect of a transfer price provision was to convert capital into income. His argument is that paragraph 13 of schedule 28AA ICTA, which Mr Peacock contends is a "huge and important signal" that transfer pricing has nothing to say about capital transactions, does not exclude capital transactions but that it precludes transfer pricing from being used to adjust capital

allowance or capital gains tax computations neither of which HMRC was seeking to do in the present case.

87. Although, as Mr Ghosh submits, there is nothing in schedule 28AA ICTA or Article 9 of the OECD guidelines that excludes equity transaction it is also true that there is nothing to include such transactions either. Given the distinction in the OECD guidelines between shareholder and non-shareholder transactions and the absence of authority, other than *ANTS* which for the reasons in paragraph 82, above we have declined to follow, that transfer pricing is applicable to shareholder transactions such as the issue of bonus shares we agree with Mr Peacock that such a transaction does not amount to "provision" for the purposes of schedule 28AA ICTA and consequently neither the transfer pricing provisions nor paragraph 31A (of schedule 26 to the Finance Act 202) are engaged.

Conclusion

88. As stated in paragraph 50 above, having concluded that the debit, arising as a result of the issue of the A Shares, did not represent a loss Union Castle's appeal cannot succeed. Accordingly, we dismiss the appeal.

Right to apply for permission to appeal

89. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

JOHN BROOKS

TRIBUNAL JUDGE
RELEASE DATE: 27 JULY 2016